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SUBJECT: Austrian Airlines in Turbulence - On the Path
of Swissair?

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Summary

¶1. The Austrian Airlines (AUA) group, after losses of Euro 173 million (\$216 million) in 2005, is on track for another loss in 2006 due to high debt levels, a burdensome cost structure, and high fuel prices. AUA's major creditors are reportedly very concerned with AUA's debts of Euro 1.8-1.9 billion (\$2.3-2.4 billion). AUA's new CEO, Alfred Oetsch, has denied rumors that the airline is facing liquidity problems. AUA's problems have unleashed a debate whether or not a strategic partner, probably Lufthansa, could save AUA. Many analysts caution that should Lufthansa subsume AUA, Munich and/or Zurich would supplant Vienna as the gateway to profitable destinations in Central, Eastern, and Southeastern Europe (CEE/SEE). In such a scenario, Austria could lose 33,000-44,000 jobs. End Summary.

AUA's Current Problems

¶2. The Austrian Airlines (AUA) group (Austrian Airlines, Lauda Air, Austrian Arrows, Slovak Airlines) reported a net loss of Euro 173 million (\$216 million) in 2005, despite higher sales, an increase in passengers, a rising load factor, and more cargo business. AUA's financial problems have worsened in the first half of 2006, and analysts expect a negative balance for 2006. Alfred Oetsch, AUA's new CEO, described the situation as "serious, but not hopeless." The problems result from AUA's high debt levels, an unfavorable cost structure, high fuel prices and increasingly fierce competition in Europe. AUA's fuel costs jumped by Euro 145 million (\$181 million) in 2005, pushing up the share of fuel in total operating costs to 17% from 14% in 2004. The fuel surcharges of Euro 62 (\$78) for a long-distance flight and Euro 12 (\$16) for a medium-distance flight covered less than half of the additional cost in 2005.

¶3. According to media reports, AUA desperately needs fresh money for investments and even to maintain daily operations. AUA's major creditors -- Bank Austria Creditanstalt, Erste Bank, BAWAG, and Raiffeisen Zentralbank are -- reportedly concerned with AUA's

current debts of Euro 1.8-1.9 billion (\$2.3-2.4 billion). There are rumors that, as part of a solvency package, creditors will buy new AUA shares following a capital increase, remit debt, and assume positions on AUA's Board.

¶4. In a recent statement, Oetsch rejected rumors of a liquidity squeeze that could endanger flight operations. Oetsch warned that AUA would take legal action against those spreading unfounded rumors. He maintained that AUA would not increase its share capital in 2006. Oetsch referred to positive business developments in the first four months of 2006, including a 13% increase in passengers. (Note: The May 25 general shareholders meeting authorized a Euro 125 million stock capital increase. AUA could use this fresh money within the next five years, provided AUA's share price is below the Euro 7.27 face value. End Note.)

Lufthansa as Savior or Scourge?

¶5. A major question remains as to whether AUA can survive alone or will need a partner. Helmut Kukacka, State Secretary for Aviation in the Ministry of Transport, Innovation and Technology, and Oetsch support maintaining AUA as an independent carrier. Some, such as Claus Raidl, CEO of Boehler Uddeholm and one of Chancellor Wolfgang Schuessel's informal economic advisors, believe AUA needs a partner now, preferably the Vienna airport company (VIE), so that AUA's problems do not translate into problems for VIE, too. AUA is

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responsible for 56.6% of VIE's passengers.

¶6. Many analysts point to Lufthansa, AUA's partner in the Star Alliance, as the most likely AUA suitor. However, Lufthansa is the primary airline at two airports - Munich and Zurich - that have underutilized capacity. Hence, there exists a risk that Lufthansa would divert profitable destinations in Central, Eastern, and Southeastern Europe (CEE/SEE) from Vienna to Munich and/or Zurich. VIE's hub function for CEE/SEE flights is an important incentive for many international firms with regional headquarters in Vienna. Studies indicate that, should Munich supplant Vienna as the gateway to CEE/SEE, Austria could lose 33,000-44,000 jobs. Prominent businessmen, including Raiffeisen Bank CEO Walther Rothensteiner, have criticized the GoA, which holds a 39.7% share in AUA, for not taking a more active role to ensure AUA's survival as an independent carrier.

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